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Public Employment and State and Local Government Finance

edited by:
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❋ Chapter 7

Public Employees: Enemies of the People?

Roy Bahl, Jesse Burkhead, and Bernard Jump, Jr.

The fiscal behavior of the public sector, and in particular of the state-local sector, poses both a significant and a fascinating analytic problem for students of public finance. It is significant because state and local governments are chronically fragile financially. In recent years, a few large cities have teetered on the verge of bankruptcy and many cities, large, medium, and small, have borrowed to meet operating expenses, have cut back their growth in employment, and have grown increasingly dependent on state and federal assistance to maintain levels of public services.

The fiscal behavior of the state-local public sector is a fascinating analytic problem because of what might be termed "output infirmity." Units of public goods output cannot be measured directly. Taxpayers do not "buy" a unit of fire protection, a unit of police protection, a unit of sanitation services. Instead, they buy inputs—the services of firemen, policemen, and sanitation workers. Taxpayers, anxious to maintain their own standards of living in the face of inflation and, very often, declining real income, foment a "revolt" against what is thought to be a wasteful and overexpanded public sector.

Public goods are characterized by benefits that are not appropriable by individuals, as is the case with market goods, and public goods are typically subject to nonexclusion, that is, the benefit that X may receive from public goods provision does not, in all circumstances, displace the benefits that Y may receive from the provision of that public good. Given these properties, studies of the fiscal behavior of the state-local sector have often concentrated attention on a range of socioeconomic and demographic variables that can be quantified, such as income, population density, or ethnic mix. Unfortunately, the results of the scores of such determinants studies that have been undertaken are not definitive; the empirical findings are often contradictory; the results are not always congruent with the conceptual model that presumably underlies the estimating technique.

The alternative approaches to analyzing fiscal behavior, by way of examining decisions in a bureaucracy, the preferences of the median voter, or the organizational characteristics of government jurisdictions, have been no more fruitful than traditional determinants analysis.

This volume has addressed the "output infirmity" by examining the characteristics, behavior, and compensation of the major factor input in the state-local sector: employment. While the research is addressed to the public employment issue, the focus throughout is on the budgetary implications of public employment practices. The concern here is less with how one might measure output in the public sector, or improve its productivity, than with the fiscal implications of public employment practices. The attention given this subject in the past has been modest, explaining the need here for some relatively straightforward description of some topics, such as trends in public sector employment and compensation, and the characteristics of public employment with respect to education, sex, and race. The fiscal implications of pension and fringe benefit policies and practices and of productivity have likewise been studied too little, and public expenditure models have all but ignored the possibility that determinants of public employee wage levels are primary determinants of public budget levels. A recasting of what is known about these subjects, in terms of fiscal implications, is the major contribution of this work.

Some interesting findings have emerged that may shed some new light on the underpinnings of the perennial fiscal problems that face state and local governments. These findings fall in four categories: the level and trend of public employment and public employee compensation; the role of wage determination and the demand for public employees in affecting public expenditure levels; the measurement of public output; and issues associated with evaluating the adequacy of public employee pension benefits and the fiscal implications of such obligations for the sponsoring state and local governments.

The trend and pattern of growth in public employment and public employee compensation is not the pattern suggested by conventional wisdom. The years 1965–72 were a catch-up period for state-local employees. National economic growth rates and real income increases facilitated rapid growth for the state-local sector. Total personnel expenditures for state-local employees were highly income-elastic—for both urban and nonurban states in the range of 1.45 to 1.75. About two-thirds of the increase in total compensation in these years was attributable to higher compensation rates; about one-third to an increase in the number of employees. However, as the national economy moved toward the 1974–75 recession, state-local personnel expenditure began to decline, first relatively, then absolutely. The decline was somewhat slower than in the private service sector such that the state-local sector had a mild countercyclical influence.

The evidence that is available does not suggest that government employees are overpaid relative to their private sector counterparts. Since the productivity of government (and private service sector) workers cannot be measured directly, it is necessary to examine the indirect evidence that is available. Comparisons of relative educational attainment, experience, and occupational mix between the public and private sectors do not sustain the common contention of overpayment.

There appears to be discrimination against blacks and women in state-local employment. Unfortunately, it is not possible to separate "market" discrimination from "malevolent" discrimination but the data that are available suggest that blacks and women are not only employed in lower-paid occupations but are also subject to discrimination within those occupations.

A review of the statistical findings of a very large number of determinants studies of government expenditures reveals that there is no consistency in model specification or in conclusions reached about why expenditures are higher or why they grow in some jurisdictions but not in others. There is little agreement about the size of price and income elasticities of demand for state-local expenditures, the importance of taste or preference indicators, economies of scale or the impact of federal and state grants-in-aid. The literature on public sector labor markets is less fuzzy. There is general agreement that public sector unionization has a small but significant effect on levels of public employee compensation. There is also agreement that an important determinant of public sector compensation is private sector compensation; there is a roll-out effect from private to public. A public employment model, in contrast with an expenditure model, combines labor market analysis with traditional expenditure determinants. This approach permits dropping the restrictive assumption that the price of public goods does not vary among jurisdictions. As applied to the police function, the public employment model indicates that an increase in real income accompanied by an increase in private sector (opportunity) wages induces an increase in compensation but a very small increase in public employment. Variations in the cost of providing a public service are more important in explaining variations in expenditures than are changes in the demand for public services. The public employment model applied to school district expenditures suggests that most of the exogenous determinants of school spending have the effect of increasing teacher salaries but decreasing employment. This is true for exogenous variables such as competitive pressures from other districts, higher opportunity wages, fiscal dependence, and teacher experience.

Any analysis of fringe benefits for state and local government employees is severely handicapped by data limitations. However, the available information on fringe benefit costs shows that they now typically equal more than 40 percent of municipal workers' pay and are growing faster than wages.

Of particular significance in fringe benefit outlays are the costs of pensions. Although many observers assume that the high cost of public employee pension means that the benefits are too generous, it is by no means clear that state and local pension plans usually provide retirement income levels that exceed generally accepted norms of adequacy. Excessively generous or not, public pensions are thought to constitute a major threat to the financial stability of some governmental units, not simply because benefits—even modest ones—are costly, but also because of past and sometimes present failures in many jurisdictions to make adequate provision for accruing pension liabilities. An assessment of the extent and severity of this so-called underfunding problem is hampered by the paucity of relevant data about current pension liabilities and probable future costs.

Almost all of the conceptual infirmities that beset the analysis of the public economy are manifested in an analytic approach to government productivity. The absence of discrete units of output, joint consumption, multiple and conflicting objectives of public programs, and reciprocal externalities among programs, particularly in local jurisdictions must, at minimum, serve to caution those who contend that productivity improvement is the solution for the public sector fiscal crisis, that service levels can be maintained and taxes reduced if attention will (simply) be directed to this area. In the absence of an ability to measure directly an improvement in the "social state" of the citizenry, it is necessary to measure the technological efficiency of specific activities, and to assume that there is a linkage between activities and outputs. In many cases it will be necessary to measure both technological efficiency and the effectiveness or quality of the local government service, even though there are difficulties in aggregation. A great many approaches to productivity measurement have been attempted other than the type of systems analysis that is most congenial to economists. Such efforts as employee incentive schemes, changes in managerial techniques, productivity bargaining, and technology transfer may be worthy of experimentation in specific jurisdictions.

The foregoing summary of the major findings of this study conveys a more favorable impression of the recent behavior of the public sector and, in particular, the state-local sector than many critics would admit. There is no evidence here that public sector employee compensation is far out of line, as compared with the private sector. Knowledge about the financial status of public employee retirement systems is generally thin, but where there is an indication that a jurisdiction's pension obligation will strain its fiscal capacity, this condition is more likely to have resulted from a failure to make adequate provision for accruing liabilities than it is because pension packages are unreasonably generous. On the other hand, there is evidence that the state-local sector does respond to fiscal stringency; growth rates are reduced when the citizenry feels the pressure of a lowered real income, as the national economy suffers from inflation and unemployment.

But these findings should not serve as justification for complacency. The taxpayer revolts of the late 1970s were as much a reaction to inadequate public services provided per dollar of taxes paid as to high and rising taxes. Few would disagree completely with the argument that there is fat in public budgets, or that public employment practices are overregulated to the point of waste. Moreover, some public employee compensation increases may impose a heavy burden on an even lower income segment of the population via rising property taxes. There is much more to be learned about how public employment practices affect budgets.

The necessity for better understanding of labor's impact on budgets may be greater than ever for fiscal planners. What does the spread of private sector unions to the South mean for state and local governments there? What should be the posture of public unions in the North when bargaining with governments whose resources are declining?

A public employment approach to an understanding of state-local fiscal behavior is promising, but there are serious gaps in our knowledge. Some of these are conceptual and may possibly be remedied by additional insight and imagination, such as the discovery of better proxies for government output, or improved techniques for tracing linkages between activities and outputs or further ingenuity in estimating government production functions. Some of the gaps are in the data, as with pensions and other components of compensation, where serious policy mistakes may be made if better information is not soon forthcoming.

It will be helpful to adopt the perspective that the behavior of the public sector is very much worth examining and that such behavior is a fascinating and complex challenge. It will not be helpful to adopt the perspective that the public sector is the "enemy of the people."